

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

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SUBJECT: Fixed Income – Home Loan Program Annual Report

ITEM NUMBER: 9

ATTACHMENT(S): 1

ACTION: \_\_\_\_\_

DATE OF MEETING: June 6, 2001

INFORMATION: X

PRESENTER(S): Michelle Cunningham  
Robert Woods

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**EXECUTIVE SUMMARY**

The California State Teachers' Retirement System (CalSTRS, System) Home Loan Program (HLP) was originally created with a dual purpose of facilitating home ownership for California teachers while providing an investment opportunity for the CalSTRS investment portfolio. This program is not a member benefit and, therefore, engages in loan origination activity consistent with the financial integrity of the program and the sound investment of the retirement fund.

One of the implementation objectives approved for the Investment Branch for fiscal year 2000/01 is to report on the continued implementation of the enhancements to the Home Loan Program as described within the Business Plan presented in July 2000, highlighting the progress achieved in developing exit strategies. In addition, staff has been directed to explore additional program enhancements, concentrating on affordability and teacher retention issues. This informational report (**Attachment 1**) is intended to fulfill that objective, and begins with an overview of the legislation that provides the basis for the CalSTRS HLP. The strategy followed in the implementation of the HLP is discussed, including a description of the loan programs offered and the exit strategies currently being considered. In addition, a process that has been established in order to identify and monitor the financial contribution of the program is provided. Finally, some conclusions are drawn, including some key issues impacting the CalSTRS HLP that are anticipated to be discussed further in the upcoming Business Planning session in July.

The challenge facing staff with respect to the HLP going forward will be to continue to manage the quality/quantity of the mortgage loan production within the CalSTRS HLP. This will necessitate staff working closely with the Correspondent Lenders in order to monitor the quality of the service being provided to the CalSTRS HLP, much like that being done by the External Equity staff. HLP staff will also be working closely with the MBS Portfolio Manager, in order to develop and implement entry/exit strategies consistent with the investment targets of the Fixed

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Income Portfolio. Furthermore, given the growth in the program, methods by which to automate and streamline the process will be evaluated and implemented. It is anticipated that one of the key issues discussed in the upcoming Business Planning session for the Investment Committee's consideration will be the management of the changes within the HLP.

## **HOME LOAN PROGRAM ANNUAL REPORT**

### **EXECUTIVE SUMMARY**

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One of the implementation objectives approved for the Investment Branch for fiscal year 2000/01 is to report on the continued implementation of the enhancements to the Home Loan Program, as described within the Business Plan presented in July 2000, highlighting the progress achieved in developing exit strategies. In addition, staff has been directed to explore additional program enhancements, concentrating on affordability and teacher retention issues. This informational report is intended to fulfill that objective and begins with an overview of the legislation that provides the basis for the CalSTRS HLP. The strategy followed in the implementation of the HLP is discussed, including a description of the loan programs offered and the exit strategies currently being considered. In addition, although there is no generally accepted performance measurement standard to judge the CalSTRS HLP, a process that has been established in order to identify and monitor the financial contribution of the program is provided. Finally, some conclusions are drawn, including some key issues impacting the CalSTRS HLP that are anticipated to be discussed further in the upcoming Business Planning session in July.

### **CalSTRS' HLP LEGISLATIVE BACKGROUND**

The CalSTRS Home Loan Program was originally created as a result of legislation in 1984. This legislation provided CalSTRS the ability to facilitate home ownership for California teachers, while presenting an investment opportunity for the System's investment portfolio.

Subsequent legislation, referred to as the Dave Elder State Teachers' Retirement System Member Home Loan Program Act (Dave Elder Act), enabled the CalSTRS Board to enter into Correspondent Agreements with private lending institutions, in order to originate and service the mortgage loans. In 1986, CalSTRS began making 15 and 30-year fixed interest rate conventional mortgage loans to members for the purchase or refinance of their one-to-four family, owner-occupied properties within California.

Senate Bill 1945 (SB1945), which was passed into law in 1998, and amended in 1999, represents the most recent legislative update to the CalSTRS HLP. Although much of the original language from the earlier Dave Elder Act was retained, SB1945 is noteworthy in that it provides the Board the option of considering opening the HLP to borrowers who are not

CalSTRS members. This legislation also permits the Board the option to provide one hundred percent (100%) financing to qualified borrowers who might otherwise have no downpayment. Previously, the CalSTRS HLP was prohibited from making mortgage loans in excess of 95% of the financing secured by the purchased home.

Currently, CalSTRS has pending legislation that will update the existing HLP loan limit of \$350,000, which has been in place since the late 1980's. Since that time, median home prices in California have increased by over forty percent and, in certain parts of the state, have doubled. This new legislation will enable CalSTRS to set the HLP loan limit at two times the conforming loan limits of the Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Association (FHLMC), whichever is higher. Allowing the HLP loan limit to increase in this manner would enable CalSTRS to respond to future economic changes without having to further amend state law.

### **CalSTRS' HLP FUNCTION AND STRATEGY**

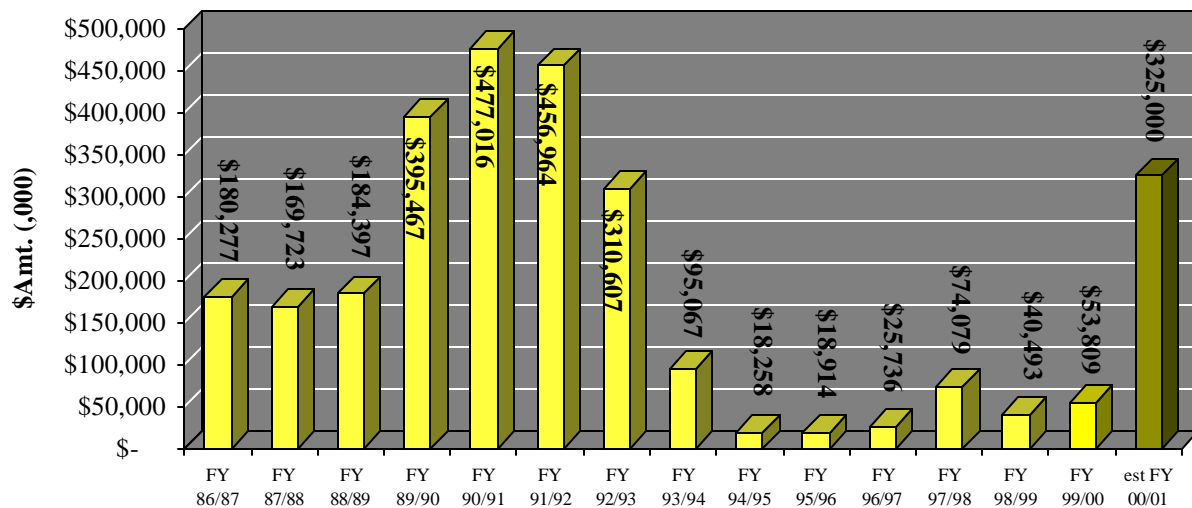
Since 1998, the CalSTRS HLP has been managed within the Fixed Income Unit. The CalSTRS Long-Term Fixed Income Portfolio includes a thirty-percent (30%) target weighting to mortgage-backed securities (MBS). As a result, the ability to originate these types of investments through the HLP as an alternative to buying them in the open market represents an attractive investment option that enhances the diversification of the Fixed Income Portfolio assets, and improves the risk/return profile of the MBS Portfolio. Furthermore, the management of the HLP fulfills Section 22362 (a) of the Teachers' Retirement Law, which states that "the Board shall give first priority to investing not less than 25-percent (25%) of all funds of the plan in obligations secured by a lien on residential realty located in the State." Therefore, the more loans generated by the HLP, the closer we are to meeting the legislative mandate.

In order to facilitate the implementation of the HLP, the Dave Elder Act enables CalSTRS to enter into Correspondent Agreements with private lending institutions in order to originate and service the mortgage loans. These mortgages are then available for inclusion in the Mortgage-Backed Securities (MBS) Portfolio or for sale, thereby providing cash flow for the funding of other investment opportunities.

### **CalSTRS' HLP**

It is estimated that, over the past fifteen years, CalSTRS' HLP has made over 23,000 mortgage loans to members, and funded approximately \$2.7 billion in loans. The following chart illustrates the amount funded each year by the HLP since inception:

### California State Teachers' Retirement System Home Loan Program - \$2.7 billion



Over the past several years, CalSTRS' HLP activity had tapered off considerably. During FY 90/91, the HLP was producing nearly \$40 million in loans each month. However, as of FY 98/99, the production had fallen to approximately \$3 million per month. This reduction was attributed to a number of factors, including a rapidly changing mortgage market that began providing borrowers with a greater number of mortgage loan options.

As a result, one of the objectives established for staff over the past couple of years has been to revitalize the CalSTRS HLP. The revitalization effort has taken primarily three forms. One of the major steps in the revitalization process was to increase the number of Correspondent Lenders participating in the HLP, in order to make the program more accessible to potential borrowers throughout California. Up until May 1999, all CalSTRS HLP mortgage loan applications were processed through Bank of America and Wells Fargo Home Mortgage (formerly Norwest Mortgage). In order to expand the range of contact for the membership, the number of Correspondent Lenders participating in the CalSTRS HLP has been increased, with thirteen lenders currently participating in the program. Furthermore, several of the new Correspondent Lenders are Credit Unions, some of which cater exclusively to teachers. In addition, as a result of the search for additional Correspondent Lenders, staff was able to negotiate a reduction in the fees, such as servicing and origination fees. This reduction in fees enables the HLP to be more competitive by passing the savings on to the borrower, in the form of less out-of-pocket costs and a better loan rate.

Another key component in the revitalization process has been to explore program enhancements, concentrating on affordability issues, such as downpayment assistance, for recruitment and retention purposes. The CalSTRS HLP has traditionally offered 15- and 30-year fixed interest rate conventional mortgage loans to members for the purchase or refinance of their owner-occupied properties within the State of California. Although CalSTRS will continue to offer competitive conventional mortgage loans for those members who like the idea of doing

business with their retirement system, two loan programs have been developed which have been designed to address the recruitment and retention issues.

- 1) “No Points/No Fees” Loan Program – Quite often, the most difficult part of the home buying process is coming up with enough money for the downpayment and fees. In addition to the traditional 5% of the purchase price required as a downpayment, the borrower typically must pay an additional 2-3% of the purchase price of the home for closing costs. The CalSTRS “No Points/No Fees” Loan Program, which was implemented in October 1999, pays the borrower’s closing costs (up to a maximum of 3%), thereby making the out-of-pocket costs associated with the loan process more affordable. For example, for a loan amount of \$100,000, the average closing costs would total approximately \$3,000. Having the option to avoid these costs allows the borrower to apply the cash typically needed for closing costs toward the 5% downpayment. In keeping with the investment mandate for the CalSTRS HLP, the “No Points/No Fees” loans require a higher loan rate and include a prepayment penalty over the first five years of the loan, in order to protect the System’s investment.
- 2) CalSTRS/CaHLIF “Zero Down Preferred” Program – CalSTRS and CaHLIF, the insurance arm of the California Housing and Finance Agency (CHFA), have joined to offer a special mortgage program also designed to make purchasing a home more affordable for CalSTRS members. This program combines a traditional 95% loan-to-value first mortgage with secondary financing provided by CalSTRS equal to 5% of the value of the home. Repayment of the secondary financing is deferred for the life of the first mortgage. However, the deferred (silent) second loan accrues interest on a simple basis for the first fifteen years, and on a compounded basis for the final fifteen years, at an amount not to exceed the interest rate on the first mortgage. The second loan must be paid off when the property is either refinanced or sold, and is 100% insured by CaHLIF, thereby representing a negligible risk for CalSTRS.

Finally, staff has developed a marketing strategy, which is considered to be the cornerstone of the revitalization of CalSTRS’ HLP. It is twofold: (1) to expand the range of program contact and (2) to better inform all potential participants of the options available to them under the program. In order to accomplish this task, staff is working more closely with the new Correspondent Lenders, in order to ensure that marketing of the CalSTRS HLP is a priority and is portrayed appropriately in their marketing materials. In addition, the HLP has been publicized recently in the CalSTRS Member Handbook, the CalSTRS Bulletin, and the Retired Educator. The HLP is also noted on the monthly retirement statement that accompanies the retirement check and the Annual Retirement Statement. Perhaps the most significant accomplishment in this area, however, has been the development of the CalSTRS HLP website. By accessing the CalSTRS website, members can obtain general information on the HLP, view a list of participating Correspondent Lenders (along with links to their web sites), check current HLP loan rates, and see the answers to frequently asked questions regarding the program.

## Exit Strategies

Given the progress made toward revitalizing the program and the subsequent increase in loan production levels, staff has devoted a considerable amount of time this year developing exit strategies for the CalSTRS HLP. In March 2001, CalSTRS was approved as a “Seller/Servicer” for FHLMC, making it the first pension fund to have attained that status. As a result, CalSTRS will be afforded the maximum amount of flexibility in developing its strategies for selling the mortgage loans produced by the HLP and thereby extracting the optimal value given the underlying characteristics of CalSTRS’ borrowers. These strategies include securitization, whole loan sale, REMIC construction, and forward sale/settlement. It is anticipated that the first securitization and sale of CalSTRS HLP mortgage loans will take place in May/June 2001. With these exit strategies in place, the CalSTRS HLP will have come full circle by becoming a self-funded, profitable mortgage loan program that distinguishes itself from others by balancing the value-added for the membership with the investment goals of the System.

## PERFORMANCE MEASUREMENT

Although there is no generally accepted performance measurement standard to judge the CalSTRS HLP, a process has been established to identify and monitor the financial contribution of the program. The following analysis identifies the program’s net contribution to operations, taking into account the cash flows, cost of funds, excess servicing, and any gains or losses taken from the portfolio as a result of the sale of mortgage loans.

The first table shows the financial contribution, using the Liquidity Portfolio yield as the cost of funds. For comparison purposes, the second table shows the same data using the MBS portion of the Large Pension Fund Index (LPF), which is the performance benchmark for the CalSTRS Long-Term Fixed Income Portfolios, as the cost of funds.

### **CALSTRS HLP FINANCIAL STATEMENT AS OF MARCH 31, 2001 USING LIQUIDITY PORTFOLIO**

	Month	Fiscal YTD
Home Loans in the Portfolio *	\$ 2,970,204.63	\$ 21,784,318.52
<b>Cost of Funds **</b>	<b>(2,683.658.47)</b>	<b>(19,465,427.54)</b>
Net Interest Margin	\$ 286,546.15	\$ 2,318,890.98
Excess Servicing Fee	\$ 38,486.22	\$ 353,478.38
Recognized Gain/Loss	0	0
<b>Net Contribution to Operations</b>	<b>\$ 325,032.37</b>	<b>\$ 2,672,369.36</b>

\* Current face of TC90 Home Loans \$470.8 million Weighted Avg. Coupon of 7.570%

\*\* **Current Face of TC90 Home Loans \$470.8 million @ .570 basis points (TC60 Yield)**

**CALSTRS HLP FINANCIAL STATEMENT**  
**AS OF MARCH 31, 2001**  
**USING SALOMON MBS LPF**

	Month	Fiscal YTD
Home Loans in the Portfolio *	\$ 2,970,204.63	\$ 21,784,318.52
<b>Cost of Funds **</b>	<b>(2,629,043.66)</b>	<b>(19,204,581.96)</b>
Net Interest Margin	\$ 341,160.96	\$ 2,579,736.56
Excess Servicing Fee	\$ 38,486.22	\$ 353,478.38
Recognized Gain/Loss	0	0
Net Contribution to Operations	\$ 379,647.18	\$ 2,933,214.94

\* Current face of TC90 Home Loans \$470.8 million Weighted Avg. Coupon of 7.570%

**\*\* Current Face of TC90 Home Loans \$470.8 million @ .5584 bps (Mthly Salomon LPF MBS Coupon)**

### **SUMMARY/CONCLUSIONS**

The fundamental objective for the CalSTRS HLP is to design a program that facilitates homeownership throughout the CalSTRS membership, while maintaining prudent investment standards. Inherent in this objective is the aspiration to design a program that adds value beyond merely providing generic conventional mortgage loans that the membership can access easily and more cost-effectively through other mortgage outlets. For example, mortgage loans for new teachers and those without an adequate downpayment are both areas of focus as the CalSTRS HLP evolves. In addition, other mortgage loan products can be offered which, when combined, result in a fully developed HLP that successfully balances both the service and the investment mandate.

The CalSTRS HLP has undergone some significant changes over the past couple of years. The challenge facing staff with respect to the HLP going forward will be to continue to manage the quality/quantity of the mortgage loan production within the CalSTRS HLP. This will necessitate staff working closely with the Correspondent Lenders in order to monitor the quality of the service being provided to the CalSTRS HLP, much like that being done by the External Equity staff. HLP staff will also be working closely with the MBS Portfolio Manager in order to develop and implement entry/exit strategies consistent with the investment targets of the Fixed Income Portfolio. Furthermore, given the growth in the program, methods by which to automate and streamline the process will be evaluated and implemented. It is anticipated that one of the key issues discussed in the upcoming Business Planning session for the Investment Committee's consideration will be the management of the changes within the HLP.